Planning for Reducing Risks

PROFITS COME FROM TAKING BUSINESS RISKS

You face risks every day. You cannot cross the street without some danger that you will be hit by a car. Getting out of bed, driving a car, and opening a business all involve SOME risk. **Risk** is simply the possibility of damage, injury, or loss.

Like individuals, business owners need to protect themselves against the risks they face. It is important for entrepreneurs to recognize potential risks they face and prepare effective strategies to deal with them. It is also useful for entrepreneurs to design "contingency plans", or alternative courses of action. Contingency plans show that the entrepreneur is sensitive to important risks and is prepared to handle risks as they occur.

MARKETS: Some of the risks that almost all businesses face involve competition, price changes, style changes, competition from new products, and changes from fluctuating economic conditions.

ACCIDENTS: Businesses also face risks beyond these market and economic shifts. For example, a merchandise shipment of tennis shoes may be destroyed in transit. A warehouse may burn down and large amounts of expensive inventory may be lost. Events like these threaten the security of a business. They cost money, and they may cause a business to fail. First, entrepreneurs must be able to identify all the possible risks they face, then decide upon preventive measures to eliminate or reduce the impact of the risks.

As an entrepreneur, there are two primary types of risk that you will face**: speculative risk and pure risk.**

- **SPECULATIVE RISK** is uncertainty as to whether an activity will result in a gain or a loss. Risks, such as building a plant that turns out to have the wrong capacity or keeping an inventory level that turns out to be too high or too low, are speculative risks. Speculative risk is unavoidable and is inherent in the nature of the private enterprise system

- On the other hand, **PURE RISK** is uncertainty as to whether some unpredictable event that can result in loss will occur. Pure risk can result only in loss, never in gain. This kind of risk consists of hazards such as a fire or a hurricane, death of key employees, or customer injuries on the premises of the business. Pure risk exists when the possibility of loss is present, but the extent of the possible loss is unknown. Pure risk is different from speculative risk because speculative risk carries the possibility of gain as well as loss.

When you start a business, you automatically assume risk; you intend to make money, but you also know that you can lose money. Not starting a business at all is the only sure way to avoid the risk. Successful entrepreneurs, however, take control over how much risk they are willing to accept and then develop plans to control the remaining risks.

Businesses face many kinds of risks, and you should realize that there is no way to avoid all of them. Sound business management procedures can minimize the losses your business may suffer from some risks, but no amount of caution and planning can eliminate risk entirely.

As an entrepreneur, you must be able to identify the risks that your business faces and take appropriate preventive measures to minimize losses. In addition, you should be aware of which losses you can protect yourself from by purchasing the appropriate business insurance. Otherwise, a lifetime of work and dreams can be lost in a few minutes.

Risk should not paralyze the zeal and enthusiasm of new entrepreneurs. They must be willing to take moderate risks when they believe there is a strong likelihood that they will succeed. For the entrepreneur, the brighter side of risk-taking is the possibility of success and increasing their wealth. Most dreams cannot come true unless some risks are taken.

HOW DO ENTREPRENEURS MAKE PLANS TO REDUCE RISK?

Effective management is clearly the best way to reduce the impact of many risks, particularly speculative risks. Careful control of financing, product development activities, production, marketing, distribution, and other management concerns help ensure that the results of most speculative risks will be profits rather than result in loss or failure of the business. Many entrepreneurs control risk by keeping fixed assets to a minimum or by renting facilities rather
than using personal funds to purchase land and buildings.

Entrepreneurs do not necessarily seek out risks; they ASSUME risks. You can reduce risk through careful planning and decision-making with activities such as the following:

1. Analyzing current and future economic and market conditions.
2. Considering the consequences of alternative actions
3. Making reasonable decisions in response to conditions as they develop and change.

WHAT METHODS DO ENTREPRENEURS USE TO CONTROL RISK?

Once entrepreneurs have identified the risks they face, they must decide what to do about them. Some risks are easier to control than others and the actions of the owner will vary with the circumstances faced by individual firms. Most owners control risk by—

1. **RISK AVOIDANCE** (eliminating the risk) is abandoning or refusing to undertake an activity in which the risk seems too costly.

2. **RISK REDUCTION** (minimizing the risk) consists of using various methods to reduce the probability that a given event will occur. Although some risks cannot be avoided, most can be appreciably reduced. The primary control technique is prevention, including the use of safety and protective techniques.

3. **RISK TRANSFER** means shifting the consequences of a risk to persons or organizations outside your business. The best known form of risk transfer is *insurance,* which is the process by which an insurance company agrees to pay an individual or organization an agreed upon sum of money for a prospective future loss. Because of the importance of insurance in controlling risks, this topic will be explored in more detail later in this unit.

4. **RISK ASSUMPTION***,* also known as risk absorption or risk retention, involves the planned acceptance of the risk of loss. In some instances, reducing certain risks may be too expensive. Generally, the small business owner w ill assume risks in which losses that occur will not produce significant financial consequences to the business. Determining the amount of loss that is significant is not a precise science.

Most entrepreneurs use a combination of methods when controlling and managing risks. How would you apply this information on risk management to the following CASE STUDY?

Jill Kearns was in her first year of college, and was running low on money. She needed to make at least $500 to cover her expenses. She considered getting a full-time job, but realized that she did not have enough time to do her studies and keep the job. Her solution was to start a small business venture with the members of a jazz band to which she belonged. They would hold jazz concerts and sell tickets to Jill's performances.

Jill's idea for this venture came from her own and a friend's interest in jazz. As the popularity of jazz has grown, she would have seen the potential for a business venture expanding. The idea of using her interest in music to earn the money was very appealing. Currently, the group members have $500 in the bank. In order to give a concert, Jill anticipated that they would have the following start-up expenses:

- an advertising cost of printing posters,
- rent on a concert hall,
- cost of printing tickets,
- and incidental expenses for transportation, telephone calls, etc.

By deferring as many payments as possible and obtaining credit, she found that they needed *$465* to hold their first concert. Jill figured their total expenses would be about $2000. By giving two shows and multiplying the ticket price by the legal capacity of the hall, she calculated that the maximum gross receipts would be $2900. The business venture would earn a profit of $900!

1. What risks are involved in this business venture?
2. How could these risks be reduced or eliminated?

(Source: PACE, Program for Acquiring Competence in Entrepreneurship), CETE/OSU, Columbus, OH)